Supreme Court, U.S.
FILED
MAR 7 1990
JOSEPH F. SPANIOL, JR.
CLERK

No. 89-255

In the Supreme Court of the United States

OCTOBER TERM, 1989

UNITED STATES OF AMERICA, PETITIONER

v.

ENERGY RESOURCES CO., INC.

UNITED STATES OF AMERICA, PETITIONER

v.

NEWPORT OFFSHORE, LTD.

ON WRITS OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE FIRST CIRCUIT

REPLY BRIEF FOR THE UNITED STATES

KENNETH W. STARR
Solicitor General
Department of Justice
Washington, D.C. 20530
(202) 633-2217

BEST AVAILABLE COPY

19 pp

TABLE OF AUTHORITIES

Cases:	Page
American Bicycle Ass'n v. *United States*, No. 88-15281 (9th Cir. Feb. 12, 1990)	14
Amos v. *Commissioner*, 47 T.C. 65 (1966)	2, 3, 7, 9
Commercial Credit Corp. v. *Schwartz*, 130 F. Supp. 524 (E.D. Ark. 1955)	10, 12
Field v. *Holland*, 10 U.S. (6 Cranch) 8 (1810)	9
First Nat'l City Bank v. *Kline*, 439 F. Supp. 726 (S.D.N.Y. 1977)	9
Mazo v. *United States*, 591 F.2d 1151 (5th Cir.), cert. denied, 444 U.S. 842 (1979)	15
Muntwyler v. *United States*, 703 F.2d 1030 (7th Cir. 1983)	2, 3
NLRB v. *Bildisco & Bildisco*, 465 U.S. 513 (1984)	13
Orleans County Nat'l Bank v. *Moore*, 112 N.Y. 543, 20 N.E. 357 (1889)	8, 9
Ribs-R-Us, Inc., In re, 828 F.2d 199 (3d Cir. 1987)	3
Sorenson v. *United States*, 521 F.2d 325 (9th Cir. 1975)	16
United States v. *Transamerica Insurance Co.*, 357 F. Supp. 743 (E.D. Va. 1973)	9

Statutes:	
Bankruptcy Code, 11 U.S.C. 101 *et seq.*:	
11 U.S.C. 105	11, 12
11 U.S.C. 365(a)	13
11 U.S.C. 507(a)(7)	14
11 U.S.C. 523(a)	14
11 U.S.C. 1129(a)(9)(C)	14
11 U.S.C. 1141(b)	5-6
11 U.S.C. 1142(a)	4
Internal Revenue Code § 6672 (26 U.S.C.)	2, 10, 11, 14, 15, 17
National Labor Relations Act, 29 U.S.C. 151 *et seq.*	13

Miscellaneous:	
60 Am. Jur. 2d *Payment* (1987)	6, 7

In the Supreme Court of the United States

OCTOBER TERM, 1989

No. 89-255

UNITED STATES OF AMERICA, PETITIONER

v.

ENERGY RESOURCES CO., INC.

UNITED STATES OF AMERICA, PETITIONER

v.

NEWPORT OFFSHORE, LTD.

ON WRITS OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE FIRST CIRCUIT

REPLY BRIEF FOR THE UNITED STATES

---

1. Respondents' first argument seeks to defend the judgment below on a ground rejected by the court of appeals. Disagreeing with the court's holding that the bankruptcy court alone has the power to direct the IRS how to apply priority tax payments received under a Chapter 11 plan of reorganization, respondents argue that the debtor itself has that power. Therefore, respondents maintain, a Chapter 11 debtor can always require the IRS to apply priority tax payments first to the debtor's trust fund tax liability,

so as to minimize the Section 6672 liability of its responsible officers. See Resp. Br. 6-19. This argument is based on the related contentions that, under the IRS's own policy, the tax payments in question are "voluntary" and that, in any event, the debtor has a common law right to designate the application of such payments. Respondents' argument is flawed in several respects.

First, respondents are simply mistaken in asserting (Br. 17) that "the IRS's policy is based only upon its interpretation of common law principles pertaining to debtor/creditor relations." As we explain in our opening brief (at 19-20), the IRS's established policy, approved by several courts, has been to allow taxpayers to designate the application of "voluntary" payments, but not "involuntary" payments. While this distinction is in line with the common law treatment of voluntary payments from debtors to creditors, the IRS's policy is not determined by the contours of the common law. Rather, the policy is designed to encourage taxpayers to make voluntary payments, thereby sparing the government the risk and expense of pursuing its legal collection remedies. See *Amos* v. *Commissioner*, 47 T.C. 65, 70 (1966). Accordingly, although respondents erroneously suggest that the concept of an "involuntary" payment should be defined in terms of administrative seizures (see Resp. Br. 8-10), the recognized IRS rule has been to treat payments collected either by levy or through judicial proceedings as "involuntary" ones that are to be allocated among the taxpayer's debts as the IRS sees fit. See *Muntwyler* v. *United States*, 703 F.2d 1030, 1032-1033 (7th Cir. 1983); *Amos* v. *Commissioner*, 47 T.C. at 69.

As the court of appeals observed (Pet. App. 12a), the IRS is the best judge of the meaning of its own

rules, and the IRS has consistently regarded payments of priority taxes made under a Chapter 11 plan to be "involuntary" for these purposes. Thus, there clearly is no merit to the suggestion that the IRS's own internal policy requires it to accept a debtor's designation of Chapter 11 priority tax payments. Moreover, quite apart from the IRS's own interpretation, respondents' contention cannot be justified under the "voluntary"/"involuntary" dichotomy that has been approved by the courts. See U.S. Br. 20-25. Under the terms of Chapter 11, the debtor must make these priority tax payments as a condition of confirmation of its plan; thus, it is *forced* to make these payments in order to stave off liquidation, which hardly constitutes a "voluntary" payment. And this compulsion to pay the priority taxes is the product of a judicial proceeding. The debtor invokes the authority of the bankruptcy court; the debtor is both protected by, and required to pay priority taxes by, the confirmation plan with which the court has the power to compel compliance. Thus, the debtor's obligation to pay priority taxes under the plan is closely analogous to a taxpayer's liability upon a judgment in a tax collection suit, which, along with a collection by levy, is the prototypical "involuntary" payment to the IRS. See *Muntwyler* v. *United States*, 703 F.2d at 1033; *Amos* v. *Commissioner*, 47 T.C. at 69. In both situations, the obligation to pay is contained in an "express judicial order in a proceeding concerning the obligation in which both the debtor and the United States are parties." See *In re Ribs-R-Us, Inc.*, 828 F.2d 199, 203 (3d Cir. 1987).[1]

---

[1] Respondents are correct, of course, that payments are not "involuntary" simply because they are designed to satisfy a

Respondents argue (Br. 8, 10-14) that the payments in question are voluntary because Chapter 11 proceedings are designed to rehabilitate the debtor and offer it certain flexibility in paying its priority taxes and debts to other creditors. But this limited flexibility does not alter the fundamental reality that, once the plan is confirmed, the debtor is compelled by court order to pay its priority tax claims. Indeed, it is the same judicial proceeding that the debtor invokes to keep its creditors at bay during the rehabilitation process that compels it to pay the priority taxes in full. Accordingly, the courts of appeals have concluded that the limited control that a debtor is permitted to exercise under Chapter 11, subject to the dictates of the confirmation plan, does not mean that its priority tax payments should be regarded as "voluntary" and subject to designation. See U.S. Br. 20-21.

---

legal obligation (see Resp. Br. 6-7); the rule permitting the designation of voluntary payments obviously is not addressed to gifts, but rather contemplates that the payments are to satisfy one or more of several enforceable debts. But that observation has no bearing on the treatment of payments under Chapter 11. The debtor has no choice but to make the payments of priority taxes as required by the plan of reorganization; it is compelled to do so by judicial order. The Chapter 11 payments thus are not induced merely by the "threat of enforced collection" (Resp. Br. 8) like voluntary pre-bankruptcy payments; rather, they are coerced by the bankruptcy court order enforcing the plan and the attendant statutory requirement that "the debtor * * * shall carry out the plan and shall comply with any orders of the court" (11 U.S.C. 1142(a)). Moreover, the policy underlying the IRS's rule, which is designed to encourage taxpayers to pay their taxes before they are compelled to do so by judicial process or other means of collection, would not be advanced at all by permitting the debtor to designate Chapter 11 payments.

Respondents also hesitantly suggest (Br. 18-19) that, in any event, a debtor has a common law right to designate payments of priority taxes under Chapter 11 because a correct interpretation of the common law "may" not reflect the voluntary payment rule. This argument, which is advanced primarily by cross-reference to the brief of amicus curiae GLK, Inc., is erroneous for several reasons. First, no reason is given why the common law treatment of payments between private debtors and creditors should necessarily control in this quite different context—where the payments in question are of tax liabiiities imposed by statute and for which Congress has provided the IRS with broad administrative collection powers. Second, there is no common law analogue to priority tax payments made pursuant to a Chapter 11 reorganization plan. A reorganized corporation, bound by the dictates of a confirmed Chapter 11 plan, is different in crucial respects from "a troubled corporation owning and controlling the funds" (Resp. Br. 19) from which a pre-bankruptcy payment is made.

Moreover, even if we accept as correct the common law rule that respondents purport to distill from two 19th century New York cases (see Resp. Br. 18), that rule lends no support to the claim that a debtor has authority to designate priority tax payments made pursuant to a Chapter 11 plan. Respondents suggest that a debtor who has "control over and ownership of the funds at the time of payment" has a right to designate how that payment should be applied (Resp. Br. 18; see also Amicus Br. 8). Respondents then argue that the Chapter 11 debtor exercises such control because the property of the estate is "revested in the debtor" under Chapter 11 following the confirmation of the plan (see 11 U.S.C.

1141(b)). But that does not cure the absence here of the only "control" that is relevant in this context —namely, the power of the debtor not to pay. Plainly, the basis for the debtor's power to designate the application of a voluntary payment (or one that it "controls") is its ability to insist upon the designation as a condition of payment. If the creditor refuses to accept the designation, the debtor can refuse to pay (thereby forcing the creditor to sue in order to collect). Compare 60 Am. Jur. 2d *Payment* § 95 (1987) ("The creditor has two choices: to apply the payment as directed, or to return the money to the debtor."). But the debtor that has sought the protection of Chapter 11 does not have the power to refuse to pay. Whatever latitude the debtor has to administer the property after it has revested, it is compelled by the court's confirmation order to make the tax payments set forth in the plan. The debtor thus lacks the necessary "control" to enable it to insist upon a particular allocation as a condition of payment. In sum, whether the right of a debtor to designate payments is viewed as turning on "voluntariness" or "control," the result is the same—a Chapter 11 debtor has no right to designate the application of priority tax payments made pursuant to a Chapter 11 plan.

2. Alternatively, respondents contend (Br. 19-25) that a court is always empowered to direct a creditor how to allocate among several debts a payment required by judicial order. This proposition, which if applied to tax collection would create a strong incentive for the government to forgo judicial collection methods in favor of administrative seizures, is flatly inconsistent with the established law upholding the IRS's policy of determining for itself the allocation of funds received in a collection suit. See U.S.

Br. 20; p. 2, *supra*.[2] The authority cited by respondents—three district court cases and two 19th century New York decisions—does not support their broad proposition, and it has no bearing on the question presented here.

First, as we have noted, there is no reason why common law principles governing private debtors and creditors should control resolution of the question presented here. Indeed, both the courts and the legal encyclopedia relied upon by the court of appeals below have recognized that, whatever the common law rule for private parties, the IRS has the power to determine how to apply tax payments received pursuant to court order. See, *e.g.*, *Amos* v. *Commissioner*, 47 T.C. at 69; 60 Am. Jur. 2d *Payment* § 104 (1987). Moreover, importation of the common law would be particularly inappropriate in the special context involved here, where the bankruptcy court's powers and the conduct of a Chapter 11 proceeding are governed by a detailed statutory code.

---

[2] Respondents erroneously suggest (Br. 24-25) that the Tax Court's decision in *Amos* v. *Commissioner*, *supra*, supports such a rule. The language that respondents quote from *Amos*, however, is taken out of context. The Tax Court there (47 T.C. at 68 n.3) was discussing in a footnote a line of cases suggesting that a court has the power to determine the application of payments. The Tax Court proceeded to reject that line of cases, however, in favor of the contrary authority giving a creditor the right to determine how to apply involuntary payments. The Tax Court concluded that "the better rule for Federal tax purposes is to permit the Commissioner's agent to apply involuntary payments in the manner he chooses." The court defined an "involuntary payment" in this context as "any payment received by agents of the United States as a result of distraint or levy or from a legal proceeding in which the Government is seeking to collect its delinquent taxes or file a claim therefor." *Id.* at 69.

In any event, there is no established common law principle conferring upon courts the general power to direct the allocation of every payment that results from litigation.[3] The only reference to court authority in the oft-repeated statement by this Court of the rule governing allocation concerns the situation where both the debtor and the creditor have failed to specify an allocation and the question has subsequently come before the court. See U.S. Br. 26 & n.9; Resp. Br. 20-21. This statement suggests no general power in the court to override a creditor's preference in applying funds received pursuant to a court judgment in partial satisfaction of certain debts. To be sure, respondents do cite (Br. 22-23) some scattered cases that take the position that it is appropriate for a court to direct the allocation of payments, rather than permitting a creditor to make the allocation in its best interests, but these cases hardly reflect an established common law rule. Indeed, the lack of any consensus on this issue is explicitly noted in the decision that respondents and amicus (see Br. 9-11, 13-14) rely upon heavily for their rule, *Orleans County Nat'l Bank* v. *Moore*, 112 N.Y. 543, 20 N.E. 357 (1889). The court there commented that "the decisions of the common-law courts have been lamentably conflicting" on this point (112 N.Y. at 549; 20 N.E. at 359-360) and stated that it did not have room to list the "vast number of inconsistent and almost con-

[3] Contrary to respondents' contention (Br. 30-31), our position on this point is fully consistent with the IRS manual provisions instructing its personnel to allocate payments in accordance with applicable court orders. Recognizing the responsibility of government personnel to comply with court orders does not preclude the government from seeking to overturn on appeal those orders that are believed to be legally erroneous.

tradictory cases * * * upon this somewhat confused branch of the law" (112 N.Y. at 558; 20 N.E. at 364). Plainly, there is no broad common law principle that undermines the authority of the IRS to determine the allocation of taxes that it collects through judicial proceedings.[4]

Respondents also argue (Br. 21-22) that even the Tax Court's decision in *Amos* v. *Commissioner*, *supra*, indicates that a court cannot permit the IRS to allocate payments in its own discretion if "the interests of other creditors are affected." The cited footnote in *Amos* (47 T.C. at 70 n.5), however, is a narrow one, apparently designed to reserve judgment on the correctness of a prior district court decision,

[4] Moreover, even if they established a common law rule giving the bankruptcy court some power to designate the IRS's application of Chapter 11 priority tax payments, the lower court decisions upon which respondents rely still would not support the decision below. Respondents studiously avoid any attempt to derive from those decisions a workable standard to be applied by a court in exercising this broad power, suggesting only that the court should seek to advance "equity and justice" (Resp. Br. 21). But this Court has noted that the most significant factor to be applied by a court if it is called upon to make an equitable allocation is the relative precariousness of the various debts, and therefore that the allocation should be made to preserve the creditor's ability to collect its debts from other sources. See U.S. Br. 28; *Field* v. *Holland*, 10 U.S. (6 Cranch) 8, 28 (1810); see also *United States* v. *Transamerica Insurance Co.*, 357 F. Supp. 743, 748 (E.D. Va. 1973). The only other standard suggested in any of the cases cited by respondents is to apply the payment ratably to all debts. See *First Nat'l City Bank* v. *Kline*, 439 F. Supp. 726, 729 (S.D. N.Y. 1977). Thus, no authority invoked by respondents lends any support to the idea that it is equitable for the court to apply the payment so as to *minimize* the creditor's ability to collect its debts, in order to confer a possible indirect benefit on other creditors.

Commercial Credit Corp. v. *Schwartz*, 130 F. Supp. 524 (E.D. Ark. 1955). As we note in our opening brief (at 27 n.11), that case is quite different from the general situation addressed by respondents because it appears that the court there acted to prevent the IRS from taking improper action—*viz.*, applying the proceeds of a judicial sale to a tax debt secured by a lien junior to that of another creditor.

In any event, even if it were appropriate for a court to exercise designation authority in a broader class of cases where creditors would be adversely affected by the IRS's designation, that does not suggest that the power should be extended to a case like this one where the IRS's proposed designation has no direct effect on any creditor. Application of the Chapter 11 plan's tax payments first to non-trust fund taxes will not directly or inevitably affect the rights of creditors at all. No matter how the IRS applies the payments, the sums it receives under the plan, as well as the sums received by all other creditors, will remain the same. The only direct effect of the designation is to determine who bears the risk of an unsuccessful rehabilitation. As explained in our opening brief (at 16, 23-24), the IRS's proposed designation increases the possibility that the responsible persons' Section 6672 liability will survive if the plan is not completed; the court's proposed designation increases the possibility that the government will not be made whole for the debtor's priority tax delinquencies. But the responsible persons are not creditors of the corporate debtors whose interests the court arguably should weigh against the government's; they are third parties to the bankruptcy whose liability arises from their failure to discharge their statutory responsibilities. The only possible effect on the interests of other creditors resulting from the IRS's allocation policy is the indirect and speculative one that it may dampen the enthusiasm of the debtor's officers in assisting the debtor's rehabilitation. See Pet. App. 13a-14a. There is no suggestion in *Amos* or anywhere else that, when a creditor receives partial payment of several debts pursuant to court order, it should be forced to allocate that payment to its disadvantage and to the advantage of a third party in order to entice that third party to act—on the theory that other creditors might ultimately benefit from that action.

3. Respondents also defend (Br. 25-37) the court of appeals' holding that the Bankruptcy Code confers upon bankruptcy courts the authority to direct the IRS to allocate payments of priority taxes first to the debtor's trust fund liability in order to minimize the responsible persons' separate liability under Section 6672. Respondents appear to acknowledge (Br. 26) that 11 U.S.C. 105 is merely a procedural provision that does not give the bankruptcy courts the power to expand upon the substantive provisions of the Bankruptcy Code. They argue (Br. 26-27), however, that, in contrast to other orders that the courts have invalidated as beyond the scope of Section 105, this kind of designation order does not expand upon those substantive provisions. The basis for this asserted distinction is not apparent.

The Bankruptcy Code expressly states that full payment of all priority taxes must be provided for in the plan of reorganization. To the extent the payments only partially satisfy the outstanding priority tax debt, it would ordinarily be a matter of the IRS's own internal bookkeeping as to which portion of the debt remains unsatisfied. The Code does not expressly authorize the court to play any role in that

determination nor is there any reason to think that Congress impliedly established such a role, since that determination has no direct effect on the other parties to the reorganization. Nor does the Code generally authorize the court to take action in derogation of creditors' statutory rights for the purpose of assisting third parties who might thereby be persuaded to assist the reorganization. Thus, the designation order here does not "fall within the scope of the Code provisions expressly enacted" to govern the payment of priority taxes (see Resp. Br. 26), and it "fashion[s] an equitable right * * * broader than that contained in the Code" (see Resp. Br. 27). The bankruptcy court's order is not designed to "carry out" (11 U.S.C. 105) any substantive provision of the Code, and therefore it is not authorized by Section 105.[5]

Respondents dispute (Br. 31-37) the government's submission that the designation order approved here disrupts the balance struck by Congress between the general goal of rehabilitation and the specific gov-

[5] If it were necessary to carry out a specific provision of the Bankruptcy Code, we do not doubt that Section 105 would authorize the court to enter an order having the effect of limiting the IRS's ability to allocate a payment among different debts. Indeed, the Chapter 11 plan implicitly contains such a designation order. If the IRS attempted to apply priority tax payments made under a Chapter 11 plan to a tax debt that is not given priority under the Bankruptcy Code, clearly the bankruptcy court could take appropriate action. Cf. *Commercial Credit Corp.* v. *Schwartz, supra* (court prohibits funds collected on the basis of senior tax lien from being applied to debt secured by junior tax lien). But here there is no basis for the court to direct an allocation among the different priority tax delinquencies, all of which are required by statute to be paid under the plan of reorganization.

ernment interest in collection of priority tax delinquencies. See U.S. Br. 30-33. But respondents' argument is devoted entirely to demolishing a "straw-man"—namely, the assertion that "collection of federal tax claims is to take precedence over all other important goals Congress sought to achieve in bankruptcy cases" (Resp. Br. 35). We agree that such an assertion of complete primacy of federal tax claims would plainly be erroneous. As we note in our opening brief (at 32), Congress carefully balanced the competing interests of the debtor, the general creditors, and the taxing authorities. That balance is reflected in the specific provisions of the Bankruptcy Code. As respondents point out (Br. 33-35), there are numerous sections of the Code that specifically impair the interests of the taxing authorities. The existence of these specific limitations on the government's power to collect its taxes in bankruptcy lends no support, however, to the decision below; indeed, it emphasizes how the decision below departs from the balance struck by Congress.[6]

[6] Respondents' attempt (Br. 28-30) to defend the approach of the court below by reference to this Court's decision in *NLRB* v. *Bildisco & Bildisco*, 465 U.S. 513 (1984), is misguided. The Court there was interpreting a specific provision of the Bankruptcy Code (11 U.S.C. 365(a)), which explicitly authorizes the bankruptcy court to allow the debtor to reject an existing collective bargaining agreement. The Court determined that, because of the tension between that provision and the policies and requirements of the National Labor Relations Act, 29 U.S.C. 151 *et seq.*, Section 365(a) can be invoked only after the court has balanced the interests of the various affected parties. That holding concerning the correct standard to be applied in invoking the authority conferred by Section 365(a) plainly has no relevance here where there is no Bankruptcy Code provision that authorizes a court to designate the application of priority tax payments.

Just as Congress impaired certain interests of the taxing authorities in the Bankruptcy Code, it also expressly protected other interests, even at the expense of competing interests of the debtor and other creditors. Thus, it identified certain tax claims as priority tax claims for which full payment must be provided as a condition of confirmation of the plan of reorganization and which are not dischargeable in bankruptcy. See 11 U.S.C. 507(a)(7), 523(a), 1129(a)(9)(C). It is these interests preserved by Congress, not the ones impaired in the Bankruptcy Code, that are undermined by the designation order approved by the court below. As we explain in our opening brief (at 34-38), the designation order severely weakens the dual deterrent and revenue protection purposes of Section 6672 by enabling the responsible persons to use the corporate bankruptcy proceeding to reduce or eliminate their separate liability.[7] And the order frustrates the determination made by Congress in the Bankruptcy Code to promote full payment of priority taxes—by forcing the IRS to increase the risk of noncollection of those taxes, thereby jeopardizing the public fisc, in order to satisfy the financial demands of the responsible persons whose misconduct created the trust fund tax delinquency in the first place.

4. Apparently recognizing that the decision below permits a corporate Chapter 11 proceeding to be used as an instrument for benefitting the responsible persons at the expense of the public fisc, respondents

[7] The courts have consistently rejected various attempts of responsible persons to use corporate bankruptcy proceedings to shield themselves from Section 6672 liability, which would not be dischargeable in their personal bankruptcy proceeding. See U.S. Br. 35 & n.16. See also *American Bicycle Ass'n* v. *United States*, No. 88-15281 (9th Cir. Feb. 12, 1990).

seek to minimize the responsible persons' culpability and instead to portray them as positive agents in the reorganization. See Resp. Br. 40 n.17; see also Amicus Br. 24-25. According to respondents (Br. 40 n.17), the responsible persons do not act with "bad intent" in converting trust funds for the corporation's use; they simply take the logical step when faced with an "unenviable Hobson's choice" of "watching a salvageable business fold" or not paying the IRS. This characterization fails to recognize that Congress has prohibited responsible officers from making such a choice; "[t]he United States may not be made an unwilling joint venturer in the corporate enterprise" (*Mazo* v. *United States*, 591 F.2d 1151, 1154 (5th Cir.), cert. denied, 444 U.S. 842 (1979)). Rather than borrowing money from the government, a responsible person is bound to comply with his obligation to turn over trust funds to the IRS; if necessary, he may file a petition for reorganization in the bankruptcy court, claiming the protection against creditors available to a "salvageable business" under Chapter 11 of the Bankruptcy Code. An officer who instead dissipates the trust fund with payments to other creditors, in a futile effort to save his business, has deliberately violated his statutory responsibility, and is appropriately held liable under Section 6672 so that the public fisc may be made whole.[8] It is

[8] Respondents erroneously suggest (Br. 40 n.17) that the responsible persons have not converted public funds for the corporation's private use because all they have done is to make a "net payroll"; there is no "actual fund of money" that contains the withheld taxes. See also Amicus Br. 24 (taxes "'fictionally' withheld"). These persons have taken the government's money just as surely as if they had dipped into a trust fund bank account. When the "net payroll" is made, the employer reports that it has withheld the appro-

entirely inappropriate for the bankruptcy court to act to divert Chapter 11 payments from first satisfying the corporation's other priority tax delinquencies, which would lessen the burden on the public fisc (see U.S. Br. 33 n.14), and instead apply them so as to minimize the liability of these responsible persons.[9]

---

priate amount of tax, and the government credits the employee with having paid that amount of tax. When the employee later files a tax return claiming a refund based on the "fictionally withheld" taxes, the government is required to pay a refund with real money. An employer in dire financial straits simply is not permitted to borrow money from the United States in this fashion. See U.S. Br. 32-33. If necessary, it must reduce payments to other creditors in order to satisfy its trust fund tax obligations. Thus, if the employer has only enough funds on hand to make a "net payroll," not to cover the withholding taxes, it is obliged to reduce the payments to employees so that the funds paid out will reflect a "gross payroll." See *Sorenson* v. *United States*, 521 F.2d 325, 328 (9th Cir. 1975).

[9] Respondents argue (Br. 35-37) that the designation order approved by the court below can aid the other creditors of the debtor by helping to avoid liquidation. Respondents posit three situations in which the responsible person yields something (money, a claim against the estate, or special technical expertise) for the assurance that trust fund taxes will be paid first. This assistance, argue respondents, will help other creditors because the bankruptcy proceedings will not be converted into liquidation proceedings, where general unsecured creditors have less likelihood of being paid. In short, respondents maintain that the persons who breached a statutory trust by paying withheld taxes to other creditors should be viewed as potential benefactors who must be wooed at the government's further expense. Respondents' argument, however, incorrectly suggests that it is the application of tax payments first to non-trust fund taxes that will drive the debtor into liquidation. Because the distributions to creditors remain the same regardless of the allocation of the tax payments, that allocation has no direct effect on the chances of successful rehabilitation. Of course, if the responsible persons withdraw their proffered support because the IRS declines to apply the payments in a manner that minimizes their Section 6672 liability, the debtor's chances of successfully reorganizing might be adversely affected. In that event, however, the specter of liquidation comes not from the IRS's allocation, but rather from the threats of the responsible persons, who are essentially seeking to hold the debtor's successful rehabilitation hostage to their demand for a personal accommodation with respect to their Section 6672 liability.

For the foregoing reasons, and those stated in our opening brief, the judgments of the court of appeals should be reversed.

Respectfully submitted.

KENNETH W. STARR
Solicitor General

MARCH 1990

☆ U. S. GOVERNMENT PRINTING OFFICE: 1990 262203 796